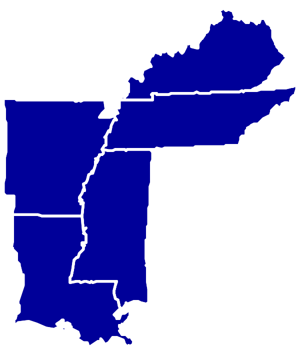
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FIRST QUARTER 1997

In Focus This Quarter

FDIC MEMPHIS REGION



■ ***Consumers Declare Bankruptcy in Record Numbers -*** **Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the Memphis Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress.** *See page 3.*

■ ***New Tax Benefits for Owners of Community Banks -*** **The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.** *See page 7.*

■ ***Savings Association Insurance Fund (SAIF) Capitalized -*** **After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF.** *See page 10.*

DIVISION OF INSURANCE

GARY L. BEASLEY, SENIOR REGIONAL ANALYST

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Dear Reader,

The prototype edition of the *Regional Outlook* for the Memphis Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook*. Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,

Arthur J. Murton
Director

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Visit the Division of Insurance online at http://fdic01/division/doi/. For more information on this publication, please call Gary L. Beasley at (901) 821-5234 or email him at Gary L. Beasley@DOI@Memphis.

The authors wish to acknowledge the assistance provided by Don Inscoe and Jon Wisnieski of the Division of Research and Statistics in providing some of the data used in this publication. Any errors are the responsibility of the authors. We would also like to thank the employees of the Division of Supervision and Division of Compliance and Consumer Affairs in the Chicago Region for providing feedback used in the development and design of this publication.

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Bankruptcy filings are increasing throughout the country and are contributing to higher consumer loan losses.**
- **The Memphis Region has the highest per capita bankruptcy filing rate of any other part of the country.**
- **Several economic and social factors, including gambling, are suspected of influencing the number of bankruptcy filings, though the degree of influence is difficult to measure.**

Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the Memphis Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

What Is Occurring in the Memphis Region?

States in the Memphis Region have experienced a rapid increase in bankruptcy filings. Bankruptcy filings have increased every quarter since the third quarter of 1994. In 1994, there were 73,701 personal bankruptcy filings in the Region. This number grew 17 percent in 1995 to 86,344. For the first nine months of 1996, bankruptcy filings equaled 83,043, 33 percent higher than the first nine months of 1995.

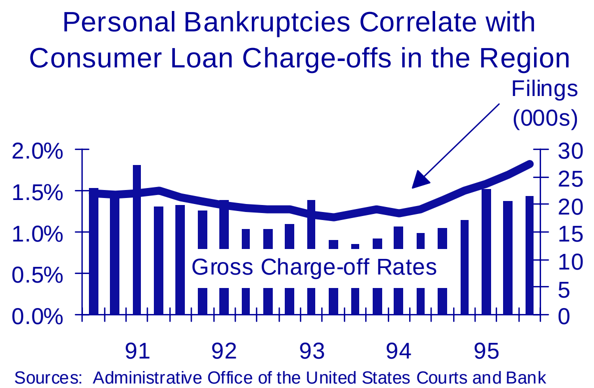
Table 1 (next page) reflects that bankruptcies per capita also are on the rise, after remaining steady or declining from 1992 to 1994. For the first three quarters of 1996, every state in the Region had higher per capita bankruptcy filings than the national average.

Tennessee stands out in this Region with the highest per capita bankruptcy rate in the nation for 1995 and for the first three quarters of 1996. Per capita filings have been consistently more than double the national average since 1991. Tennessee, with 28 percent of the Region's population, accounted for 42 percent of bankruptcy filings in the Region during the first nine months of 1996. Filings in western Tennessee are consistently higher than in the middle and eastern districts of the state.

Chart 1 shows the rising trend in consumer loan losses in the Memphis Region and the close relationship between these losses and personal bankruptcy filings.

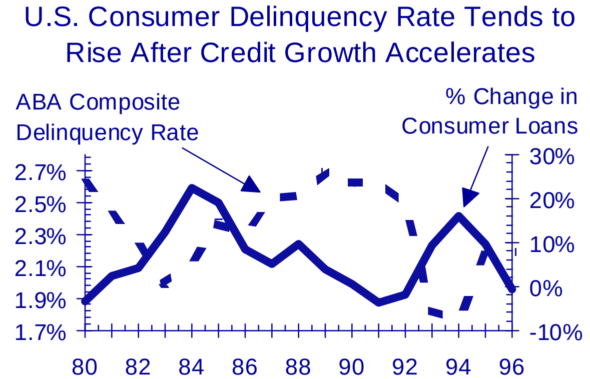
Why Are Consumer Credit Losses Rising in an

CHART 1



Sources: Administrative Office of the United States Courts and Bank and Thrift Call Reports (RIS). Based on a design by the FDIC's Division of Research and Statistics.

CHART 2



Sources: American Bankers Association and Federal Reserve Flow of Funds

PROTOTYPE

Expanding Economy?

The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more willing to incur debt and banks are more willing to lend. Chart 2 (previous page) shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this credit expansion.

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings for 1996 will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors, many of which are interrelated.

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. Among the factors identified by the report as important are:

- inadequate health insurance;
- inadequate auto insurance;
- a large percentage of self-employed workers;
- garnishment of wages;
- high debt-to-income ratios; and,
- high divorce rates.

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

Possible reasons for high bankruptcy rates in states in the Memphis Region vary. The SMR study indicates that Tennessee and Mississippi, the two states in the Region with the highest bankruptcy rates, are the only states in the Region that do not require auto insurance. Tennessee also is noted for having high divorce rates, along with Arkansas and Kentucky. Lack of health insurance is cited as a leading cause of bankruptcy in Mississippi (19.2 percent without coverage), Arkansas (19.8 percent without coverage) and Louisiana (22.1 percent without coverage).

Table 1

Bankruptcy Rates Per Thousand Persons

	1992	1993	1994	1995	3rd Qtr 1996 Annual.	3rd Qtr 96 State Ranking
Arkansas	3.20	2.70	2.64	3.60	4.93	10
Kentucky	3.68	3.07	3.02	3.60	4.66	13
Louisiana	3.10	2.76	2.77	3.26	4.40	14
Mississippi	4.46	3.79	3.62	4.28	5.40	5
Tennessee	7.55	7.01	6.58	7.19	8.73	1
Memphis Region	4.67	4.15	4.00	4.63	5.49	NA
United States	3.52	3.15	3.00	3.33	4.15	NA

Source: Bankruptcies - Administrative Office of the United States Courts
Population - Census Bureau

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Does Gambling Play a Role?

News articles often point to gaming as a source of increasing bankruptcies. While gambling is likely a contributor to some of the bankruptcy filings in Mississippi and Louisiana, the per capita filing rates do not indicate a notable increase over the period in which gaming has experienced its growth. For example, in Mississippi, per capita bankruptcy filings were lower in 1995 than 1991. The state's first casino opened in August of 1992.

The effect of gaming on bankruptcies may extend beyond excessive gambling losses incurred by individuals. A recent article in ***The Times***, Shreveport, Louisiana, noted that overall increases in bankruptcy filings in the state have included a dramatic increase in the number of Chapter 13 filings. A bankruptcy judge quoted in the article attributed the increase in Chapter 13 filings to service-wage gaming employment provided to individuals who were often previously unemployed with no assets or wages to protect through bankruptcy action.

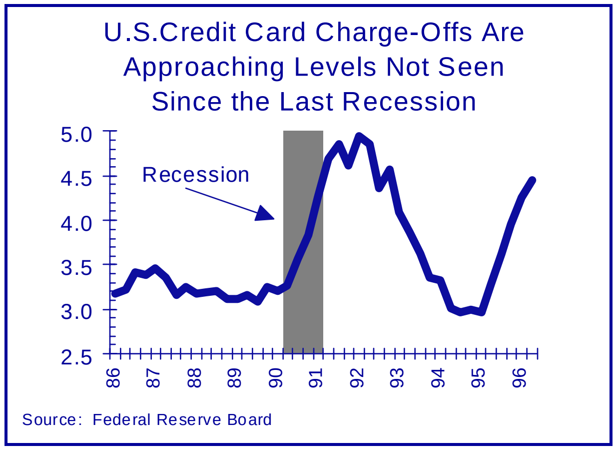
It also is important to note that gaming's affect on bankruptcy rates may be spread across adjoining states; therefore, the affect of gaming on state bankruptcy trends could be somewhat diluted. For example, a study on individuals who gamble in Mississippi indicated that 70 percent of casino patrons come from outside of the state.

Implications for Insured Institutions

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 3, credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

CHART 3



Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Consumer lending in the Memphis Region, including credit card loans, represented 21.88 percent of total loans as of the end of the third quarter. Credit card loans comprised 2.27 percent of total loans. Additionally, 18 institutions in the Region reported a 50 percent or higher concentration of credit to consumers, while five institutions reported a 25 percent or higher concentration in credit card loans.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions. Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst
Gary L. Beasley, Senior Regional Analyst

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- **Potential benefits are substantial. A layer of tax expense has been eliminated.**
- **Eligibility is restricted and requires care to maintain.**
- **While no application to the banking agencies is required, the new tax structure has supervisory implications.**
- **The new tax structure has some potential drawbacks.**

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts, and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes, and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions therefore may need to act quickly since changes in either of the above areas may be time consuming.

Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under $500 million in assets that are not part of a group with more than $500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals, estates, and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock Ownership Plans (ESOPs) and other stock bonus

Table 1

Number of Banks with Under $100 Million in Total Assets

	National	Non-Member	State Member	Total
Arkansas	26	106	14	146
Kentucky	43	147	3	193
Louisiana	13	103	1	117
Mississippi	12	48	1	61
Tennessee	10	122	4	136
Total	104	526	23	653

Source: Preliminary Bank Call Reports as of 9-30-96 plans, may not hold shares in subchapter "S" corporations. Once the subchapter "S" election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Number of Eligible Institutions

While exact figures on the number of eligible institutions are not available, the number of small banks may provide insight into where the tax election may be seen. As Table 1 (previous page) shows, there are about 653 banks in FDIC's Memphis Region with under $100 million in assets. Table 2 shows that there are 319 banks with under $50 million in assets. It is expected that a large percentage of these companies would meet the eligibility requirements. Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Benefits to Shareholders

The tax benefits of the "S" corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders' personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation's taxable income. Distributions formerly paid directly to the IRS by the institution would generally be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies.

Adding value and flexibility to the "S" corporation structure is the ability to wholly own other "S" corporations. These rules allow holding companies and their bank or savings association subsidiaries to be "S" corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to "S" corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for "Built-in Gains Tax" (BIG tax) to determine any tax at the corporate level.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various "phantom bank mergers" or change-in-control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.
Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special

Table 2

Number of Banks with Under $50 Million in Total Assets

	National	Non-Member	State Member	Total
Arkansas	10	57	5	72
Kentucky	20	67	2	89
Louisiana	6	55	0	61
Mississippi	5	23	0	28
Tennessee	1	66	2	69
Total	42	268	9	319

Source: Preliminary Bank Call Reports as of 9-30-96 expertise for the bank in areas such as tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital in situations where growth is strong or delinquent assets are rising.

Other Drawbacks

To receive the benefits of the subchapter "S" election, the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

The states of Connecticut, Michigan, New Hampshire, New Jersey, **Tennessee** as well as the District of Columbia do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend payments to fund debt payments on stock loans.

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks.

Ronald L. Spieker, Chief,
*Depository Institutions Analysis Section **

For More Information

Subchapter S Election for Federal Income Taxes. FIL-91-96.

* Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Almost 300 banks and thrifts in the Memphis Region paid $170 million of this total.**

- **Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.**

- **The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.**

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was $3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.

- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.

- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.

- Disparity between SAIF and BIF premiums created strong economic incentives for institutions to transfer SAIF-assessable deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

Nearly 25 percent of the Memphis Region's institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of

What Significant Actions Were Taken?

Table 1

Memphis Region Institutions Affected by SAIF Special Assessment

# of Institutions Affected and Total Assessment by Type	Mutual	Savings Banks	S&L	State Member	National	Non-Member	Total
Arkansas	0	7	8	7	20	29	71
Kentucky	0	32	15	3	7	6	63
Louisiana	4	10	24	3	4	9	54
Mississippi	2	8	6	2	5	16	39
Tennessee	0	19	5	2	9	11	46
Total	6	76	58	17	45	71	273
Assessment ($000s)	5,289	78,489	29,859	8,885	27,271	20,335	170,128

Source: Derived from early estimates from the FDIC's Division of Finance.

Special Assessment: In order to address the immediate problems, *the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions*. The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

- Exempted weak and other specifically defined institutions from paying the special assessment.

- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

Early estimates are that there will only two exempted institutions in the Memphis Region. This number of exempted institutions is small compared with the estimated 273 institutions in the Region that paid about $170 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

TABLE 2

SUMMARY OF 1997 ASSESSMENT RATES *			
1997 ADJUSTED BIF & SAIF SCHEDULE			
CAPITAL GROUP	SUPERVISORY SUBGROUP A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
EXEMPT INSTITUTION SAIF SCHEDULE			
1	23	26	29
2	26	29	30
3	29	30	31
FICO ANNUAL RATES			
BIF INSTITUTIONS		SAIF INSTITUTIONS	
1.30		6.48	

* CENTS PER $100 OF DOMESTIC DEPOSITS

SOURCE: FDIC'S DIVISION OF INSURANCE

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about $800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points* (see Table 2). As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board lowered the rates on ongoing assessments paid to the SAIF. The FDIC Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit initially from the lower SAIF assessment rates. They will pay according to the 23- to 31-basis point schedule through year-end 1999, unless they choose to make a pro rata payment of the special assessment in the interim.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, approximately 10 percent of the Memphis Region's institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Chicago Senior Regional Analyst

For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

Memphis Region Downshifts to Moderate Growth

- **Employment growth in the Memphis Region recently slipped below the national average, breaking the Region's seven-year pattern of above-average gains. Some indicators suggest that the Region's future economic growth will approximate the national pace and thus will be less vigorous than in the recent past.**
- **The Region is expected to remain a magnet for both population and businesses. Diversification of the Region's economic base should boost its fortunes, although some of the newly expanding sectors may increase the Region's sensitivity to business cycles.**
- **As the Region's economic base diversifies, banks and thrifts may benefit from the opportunity to diversify their loan portfolios and funding sources.**

Regional Growth Fueled by Population Gains

Strong population growth has helped foster healthy economic growth in the Memphis Region. An expanding labor force has provided workers needed for the Region's expansion into industries such as autos and parts, health care, distribution and delivery services, gaming, and financial-service operations. At the same time, the Region's above-average population growth has triggered robust local demand for housing, retail business, and various services, all of which generated positive spill-over effects to other sectors.

In contrast to the national pattern, four of the Memphis Region's states experienced slightly stronger population growth in the three years ending in July 1995 (see Table 1). Within the Memphis Region, Tennessee and Arkansas stand at one extreme, with in-migration accounting for about 60 percent of their rapid population growth. Louisiana, at the other extreme, experienced a slowing of population growth even though population outflows lessened from over 20,000 persons in 1993 to 6,800 in the year ended July 1, 1995.

Job Growth Stops Outpacing the Nation

Nonfarm job growth in the Region and the nation slowed in tandem during 1995. In 1996, employment growth in the Region slowed even more and started lagging the national pace. This contrasts sharply with the previous seven years, when Regional job growth exceeded the national average, regardless of whether the national

Table 1

Domestic In-Migration Helps Spur Memphis Region's Population Growth (From July 1, 1990 through July 1, 1995)

	Population Change (Average Annual %)		Population Change (# of Persons)	Net Domestic In-Migration (# of Persons)	Share of Population Increase Due to In-Migration
	7/1/90 to 7/1/92	7/1/92 to 7/1/95			
Arkansas	0.9%	1.2%	129,487	77,883	60.1%
Kentucky	0.8%	0.9%	167,691	62,576	37.3%
Louisiana	0.7%	0.5%	124,977	-56,443	----
Mississippi	0.7%	1.1%	119,985	25,802	21.5%
Tennessee	1.3%	1.5%	365,407	217,044	59.4%
Memphis Region	0.9%	1.1%	907,475	326,862	36.0%
United States	1.1%	1.0%	13,351,823	0	----

Source: Bureau of the Census

economy was experiencing a business cycle recession or expansion (see Chart 1 next page).
The Region's relatively faster pace of job growth began in 1987 but was especially strong from mid-1991 through late 1994 (see Chart 1). *Several situations contributed to this sustained period of faster growth in the Memphis Region*. First, the *Region's unemployment rate in the mid-1980s was about 3 percentage points above the national rate, indicating the existence of a large pool of available labor*. Not until 1990 was this gap reduced to less than one percentage point.

As tightening labor markets threatened to slow employment growth, a period of in-migration began, as discussed above. *Net population inflows expanded the Region's population by about 252,000 from 1992 through 1995* and went hand-in-hand with the continuation of above-average job growth.

Personal income growth in the Region has mirrored the employment situation. Expansion of households' incomes slowed earlier this year to an annual rate of approximately 4.5 percent from 5.5 percent or higher in the prior two years. Even so, recent increases still outpace the inflation rate by a comfortable margin. This means that households' purchasing power continues to expand, which has fostered levels of consumer confidence and expectations that are the highest since the late 1980s. *Despite these favorable economic conditions, the Region has experienced both high and rapidly growing bankruptcy filings by individuals* (see ***Consumers Declare Bankruptcy in Record Numbers)***.

Implications: To the extent that there is no longer a widespread excess of labor available for hire, one attraction of the Region to employers has faded. However, if net in-migration continues to add approximately 90,000 people per year to the area, then tight labor markets should not be a restraint.

While the Region seems poised to perform relatively well, it may not be able to maintain the robust growth pace of recent years. The boost to employment -- and thus to incomes, retailing, and housing construction -- that accompanied the establishment of auto plants and transportation hubs over the past decade, for example, is fading. *Bankers will need to review carefully decisions based upon assumptions of continued rapid growth in the Memphis Region, from lending options to the establishment of new branches.*

Housing Markets Strong for Third Year

As measured by building permits, housing markets in the Region are mirroring the national trend by remaining in high gear for the third consecutive year. Building activity in Tennessee is especially vigorous, as the state accounts for 28 percent of the Region's population but almost 43 percent of its recent building permits. Strong advances in existing-homes sales are continuing in Tennessee, Mississippi, and Arkansas. Sales in Kentucky and Louisiana are healthy but have failed to advance beyond the high levels reached several years ago (see Chart 2). Pressure on median resale prices varies by location. Double-digit rates of increase have been recorded recently for several metro areas including **New Orleans, Memphis, Chattanooga** and **Nashville**.

Implications: Positive economic conditions, rela-

CHART 1

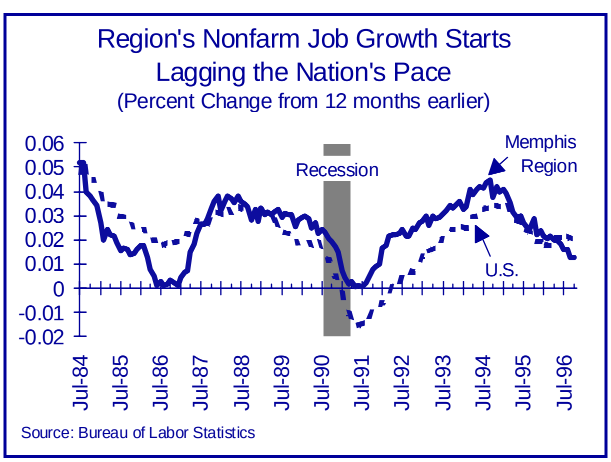


CHART 2

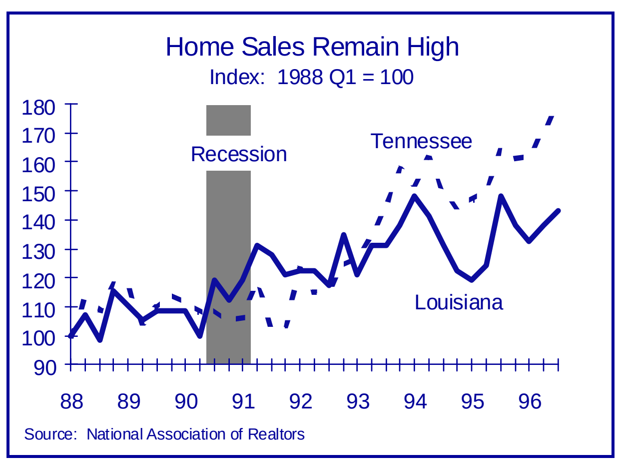


TABLE 2

SCORES FOR REGIONAL REAL ESTATE MARKETS' INVESTMENT POTENTIAL	KNOXVILLE	MEMPHIS	NASHVILLE	NEW ORLEANS
DOWNTOWN OFFICE	84	71	79	58
SUBURBAN OFFICE	86	85	91	86
INDUSTRIAL	89	88	88	83
RETAIL	82	76	85	80

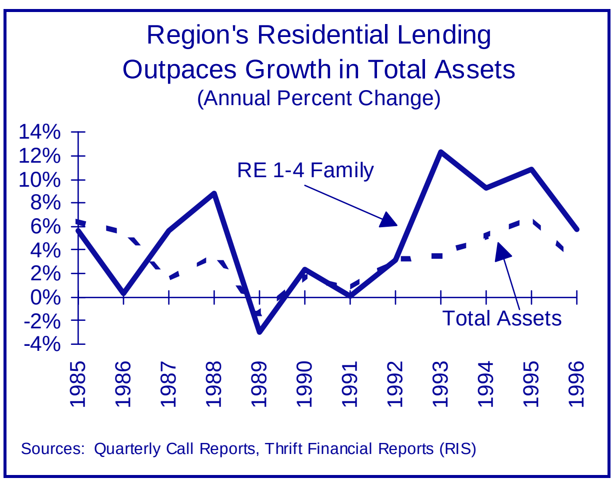
SCORING SYSTEM IS: 95+ EXTRAORDINARY; 90-94 EXCELLENT; 80-89 GOOD; 70-79 FAIR; 60-69 POOR; 59 AND BELOW SPECULATIVE

SOURCE: E&Y KENNETH LEVENTHAL REAL ESTATE GROUP

tively low mortgage rates, and net population in-migration have tightened conditions in some of the Region's residential markets. As builders respond with new construction, however, *vacancy rates have risen and rents have softened in some markets.*

Developments in the housing market are becoming increasingly important to this Region. Residential real estate loans comprised up 20.6 percent of insured institutions' assets in the five-state Region in the third quarter, and these assets have grown slightly faster than total assets (see Chart 3). A cyclical slump would have a substantial affect on this business as growth in residential lending would be expected to slow or even turn down. *Lenders would then be faced with finding alternative lending and investment opportunities, chasing a declining demand for residential loans, or possibly sacrificing income.* Therefore, when or if such circumstances arise, both lenders and examiners need to be watchful for competitive and other pressures that could increase risk profiles. Financial difficulties experienced by households also would be felt in consumer loan portfolios.

CHART 3



Commercial Real Estate Reviving

Regional conditions in commercial real estate markets generally mimic those seen nationwide:

- Vacancy rates for office and industrial space are falling and are sufficiently low in most markets to trigger new construction.
- Suburban office space is tighter than in downtown locations, which often have substantial amounts of lower-quality space still available.
- Demand for industrial and warehouse space is spurring some projects.

In addition, the growth of casinos and gaming in the Memphis Region has triggered some localized pockets where construction of hotel, eating, and tourist-related facilities has been brisk.

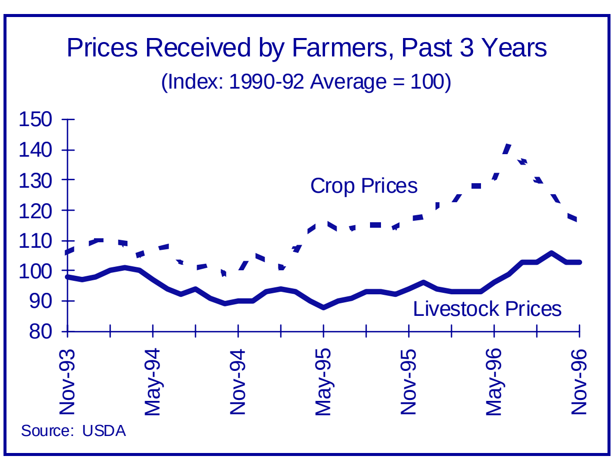
Nashville and **Knoxville** were ranked relatively high with respect to investment potential in a recent evaluation of national real estate markets by ***E&Y Kenneth Leventhal Real Estate Group*** (see Table 2), but other metropolitan areas in the Memphis Region also scored favorably. **Louisville**, not shown in Table 2, had favorable scores for suburban offices (86) and for industrial space (89). Contributing to the favorable environment are the absorption of excess space that resulted from the building boom of the 1980s and the Memphis Region's substantial in-migration of businesses and people.

Even so, several markets have seen vacancy rates stabilize or turn up for certain property categories. This reflects an upswing in construction that started several years ago, negative absorption associated with the vacating of existing buildings, and increased building of speculative (rather than build-to-suit) properties.

Within the Region, various localities have experienced bursts of construction for casinos and associated resort and hospitality business. As is the case for any rapidly expanding industry, some facilities that look profitable in the planning stage could face changing -- and potentially less favorable -- conditions upon completion. For example, troubles last year with a casino in **Tunica, Mississippi** forced the parent company into bankruptcy. In **New Orleans,** the operation of Harrah's Jazz, Inc. was shuttered after just six months and also led to a bankruptcy filing. Current plans in the Region include expansion in the **Biloxi** area that will increase slot-machine capacity by 40 percent, and a fifth riverboat that will start operating during 1997 in the **Shreveport-Bossier** market.

Implications: *Commercial real estate construction is on the rise, and exposures relative to capital are substantial at some insured institutions.* Although some of the building seems clearly warranted, the potential for over-building and the current age of the business-cycle expansion should be factored into lending decisions. In light of long lags between loan approval and occupancy for many commercial projects, lenders may need to give careful consideration to the capacity of a local market to absorb more space in the future. This situation is particularly true when the projects are speculative rather than build-to-suit.

Chart 4



The casino, gaming and resort sector contains its own set of risks. The challenge of generating sufficient revenues to service debts will intensify as more casino and gaming projects are completed. Since Mississippi's first casinos opened in 1992, expansion has pushed it to third in the nation with respect to total casino employment and gaming revenues. How much additional capacity can be operated profitably both in the Region and nationwide, remains an open question that warrants continued attention.

Although the Region's banks and thrifts typically do not lend heavily to gaming firms, they do participate in financing ancillary demands for housing, consumer borrowing, and small business enterprises. Insured institutions are at risk if local gaming operations falter, triggering negative spillover effects on the local communities. Those involved with insured institutions operating in markets influenced by the gaming industry should continue to review the effectiveness of policies and procedures designed to limit, monitor, and measure risk from this and related businesses.

Agriculture: A Good Crop Year After All

Farmers in the Region are reporting strong crop production results. Significantly increased output was reported for sorghum, soybeans, and tobacco while cotton and rice production was similar to the prior year. Corn output reached record levels in Mississippi and Louisiana.

Crop prices have eased from their summer highs, which were driven by fears of weather-related supply shortages (see Chart 4). Heightened global competition also contributed to the rise in crop prices. Domestic corn and wheat producers are facing not only robust U.S. production but also aggressive marketing and export subsidies by such competitors as Argentina and the European Union. The outlook for soybean exports appears stronger, however, in light of strong demand from Pacific Rim countries and lower-than-expected production in South America. Looking ahead, the U.S. Department of Agriculture (USDA) expects that average prices this marketing year for corn, wheat, and soybeans will fall from 1996 levels but will remain elevated relative to the previous five years. The futures markets generally agree, as some contracts that mature over the 1996/1997 marketing year are trading 20 to 40 percent below lifetime highs reached earlier this year.

Other Memphis Region crops also posted higher prices during 1996. With respect to rice, where this Region produces about 64 percent of the nation's crop, the recent price of $9.95 per hundred-weight is down 60 cents from the summer. Even so, rice prices remain well above the $7.58 per hundred-weight average of the previous five years. Prices for cotton, another key crop in the Region, stabilized in the fourth quarter after sharp declines in July and August. Important for Kentucky and Tennessee farmers is that burley tobacco prices are up 4 percent this year according to October data from the USDA. Table 3 shows the major agricultural commodities for states in the Memphis Region.

Overall livestock receipts are expected to be higher for the year, although cattle producers are experiencing weakness. Poultry, pork, and dairy receipts are being boosted mainly by higher prices, although dairy prices have weakened recently. While cattle prices also have risen from 1995 levels, increased feed costs earlier in the year contributed to the USDA forecast that cattle receipts will be the lowest so far in the 1990s. If livestock and milk prices either continue rising or stabilize and feed costs ease in response to strong harvests, then profit margins for livestock and dairy farmers should improve in the year ahead.

Implications: Reflecting higher output and stronger prices during the year, the USDA has forecast $51 billion in net farm income for 1996, up from $35 billion in 1995. The results for 1996 were so favorable, however, that *some experts are concerned that high income levels may lead to a recurrence of some of the excesses of the 1970s and 1980s,* when farmers relied on unsustainable cash flows to take on new debt to purchase additional land and equipment. Given the potential for volatility in farm incomes, lenders must properly factor this into their credit decisions when extending loans to this sector.

Table 3

Major Commodity Rankings Based on 1994 Cash Receipts

	AR	KY	LA	MS	TN
Cattle	5	2	5	5	1
Cotton	4		1	2	3
Soybeans	3		4	3	5
Broilers	1			1	
Tobacco		1			4
Rice	2		2		
Dairy		5			2
Corn		4			
Sugar Cane			3		
Horses/Mules		3			
Aquaculture				4	

Source: USDA

Overall, the year's results should lessen concern about banks with lending portfolios dominated by farm credits. Moreover, while the USDA projects total farm debt will rise by $4 billion during 1996, it also notes that the increase does not represent cause for concern at current interest rates and income levels.

Joan D. Schneider, Chicago Regional Economist
Gary L. Beasley, Senior Regional Analyst

Financial Markets

- **The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.**
- **The performance of the Memphis Region's bank stock index has been consistent with the S&P 500, but it has underperformed the S&P Composite Bank Index so far this year.**
- **Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.**
- **New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.**

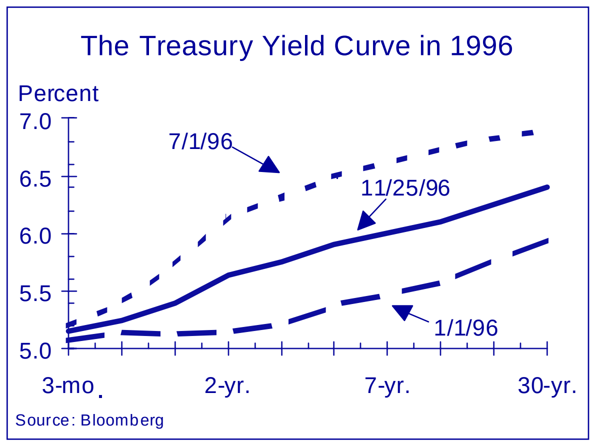
Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost nearly 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the Memphis Region's banks fared slightly better. The value of securities holdings for all Call Report filers in the Region declined by only 1.33 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition price of each instrument.

CHART 1



The Memphis Region's Bank Stock Performance

TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE

	US Treasury 30-year bond $100,000 Par 7.25% Coupon 7.75 yrs until maturity		FNMA Mortgage pass-through $100,000 Par 7.5% Coupon 7.59 yrs WAL		FNMA Callable Agency bond $100,000 Par 7.55% Coupon 7.58 yrs until maturity		Total	
Date	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period
11/25/96	$107,375	3.84%	$100,280	2.19%	$102,240	2.14%	$309,895	2.74%
7/1/96	$103,406	(7.08%)	$98,130	(3.90%)	$100,100	(4.68%)	$301,636	(5.27%)
1/1/96	$111,281		$102,110		$105,020		$318,411	

SOURCE: Bloomberg

PROTOTYPE

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the Memphis Region's banks. The Memphis Regional Bank Index (MRBI), created by the Division of Insurance (DOI), consists of the Memphis Region's 24 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The MRBI, which is weighted by total market value of shares outstanding, has gained 20 percent on the year, with performance closely tracking the S&P 500. However, the MRBI has significantly underperformed the S&P Bank Composite Index so far this year* (see Chart 2). The MRBI does not share any institutions with the S&P Bank Index.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 (next page) plots this concept through 1995.

The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

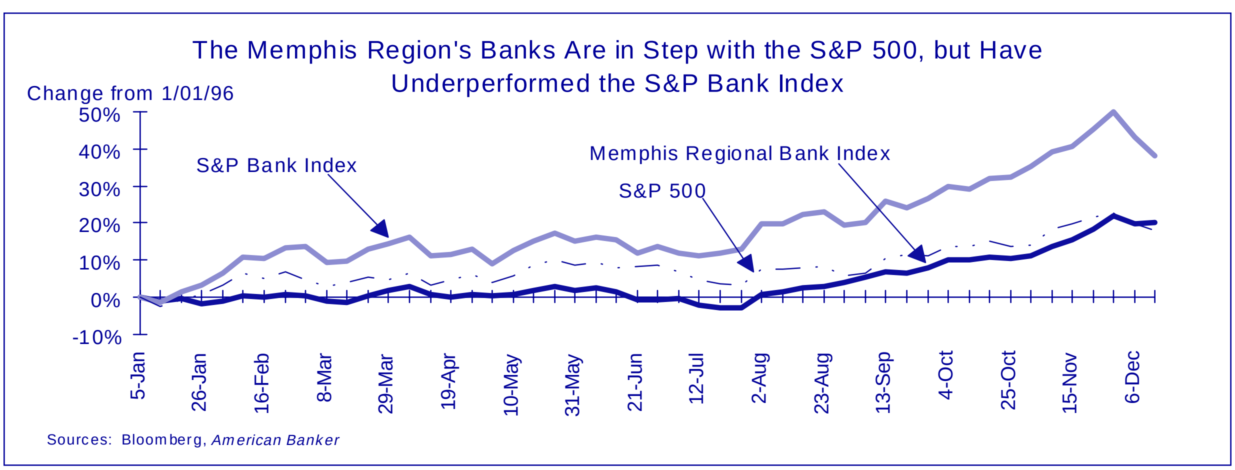
Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield Curve Twists

Managing earnings exposures to changes in the yield

CHART 2



PROTOTYPE

curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. *Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).*

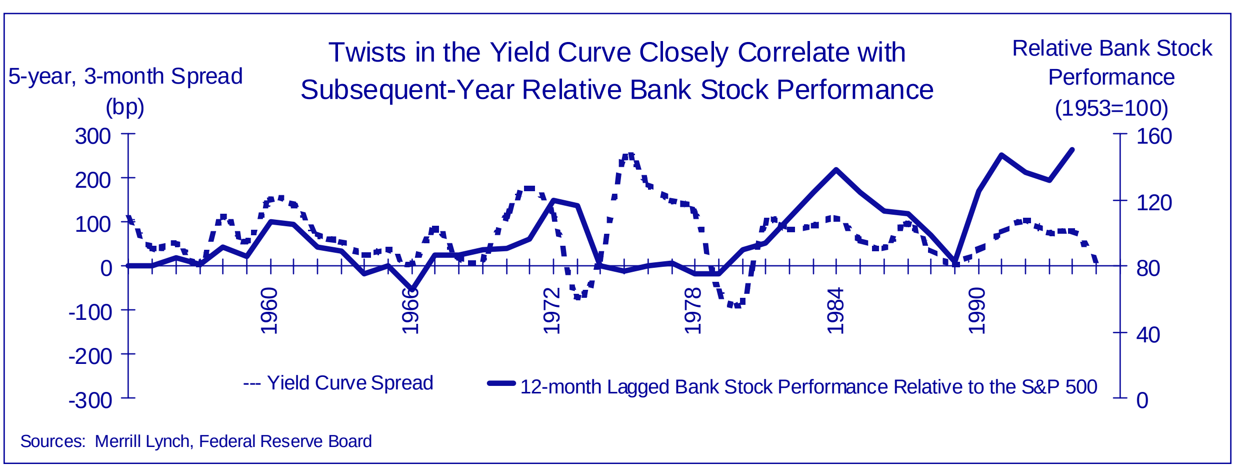
YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.

Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversified with most volume being derived from speculators and traders for proprietary accounts.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

CHART 3



Current Regional Banking Conditions

- **Banks in the Memphis Region continued to add to their loan portfolios during the third quarter with residential mortgage lending contributing much of the growth. Construction and development lending also exhibited noteworthy levels of growth.**
- **Core earnings were very strong for most banks and thrifts in the Region during the third quarter. However, a one-time charge related to the capitalization of SAIF adversely affected earnings of 273 insured institutions in the Region, causing a quarterly loss for thrifts as a group.**
- **The overall credit quality of loan portfolios remains good; however, pockets of weakness are noted in the installment and credit card portfolios which continue to experience a steady rise in the level of**

Third Quarter Reports Reflect Continued Loan Growth, and Few Credit Quality Problems.

Loan portfolios grew at annualized double-digit rates for banks located in Louisiana (14.5 percent) and Tennessee (11 percent). While loan growth was not as strong in Mississippi and Kentucky (9 percent for both), these states experienced growth exceeding the national average of 7.1 percent. Arkansas lagged the national average slightly, with loan growth of just 5.4 percent. This condition reflects a continuing trend in which a greater percentage of assets are in loans rather than in securities (see Chart 1). Loans and leases account for a slightly higher percentage of assets for banks in the Region than for banks nationwide. A sizable amount of the growth in loans has been funded by a reduction in securities holdings which declined by an annualized rate of 13.5 percent. Not surprisingly, the largest declines in securities holding occurred in the states with the highest loan growth. On an annualized basis, securities portfolios declined 21.6 percent in Louisiana and 13 percent in Tennessee.

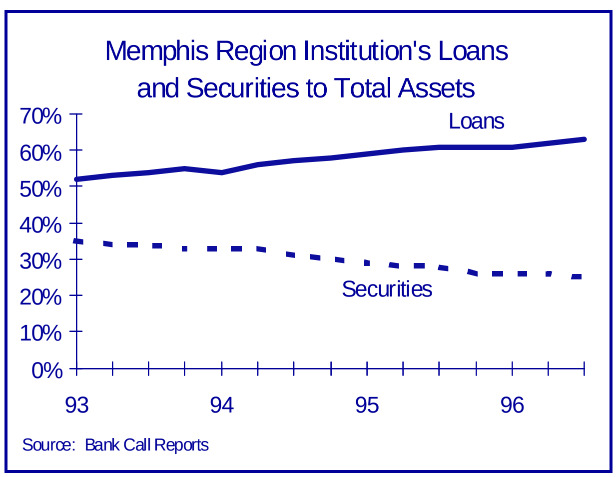
The Region's banks have taken advantage of generally strong demand for 1 to 4 family mortgages, increasing holdings to an amount equaling 28 percent of total loans, the largest category of lending. In addition, growth in residential mortgage lending accounted for slightly over one quarter of all loan growth for the third quarter. The growth in this lending area varies across the Region, but is generally in line with recent population trends. For example, the greatest population increase has occurred in Tennessee which has experienced one of the highest growth rates for 1 to 4 family mortgages (see ***Memphis Region Down Shifts to Moderate Growth***).

Institutions continue to rapidly book loans for construction and land development (C&LD), which have grown by 39 percent since the end of 1994. There are now 57 banks and 17 thrifts in the Region which have devoted more than 10 percent of total loans and leases and 100 percent of Tier 1 capital to C&LD loans (see Table 1 next page). Two markets which have seen a significant increase in the number of multifamily projects started or announced this year, **Little Rock** and **Memphis,** anchor the only field offices in the Region with over $1 billion of outstanding C&LD loans.

Increased attention to underwriting standards and pricing for both C&LD and residential mortgages seems in order considering the increasing importance of this lending to the health of insured institutions. Additional factors highlighting the need for monitoring these types of loans include:

- Previous overbuilding of both commercial and multifamily properties in some of the Region's metropolitan areas;

CHART 1



- Significant declines in collateral values for 1 to 4 family residential property, particularly in Louisiana, during the energy bust of the mid 1980s; and,

- The reinvestment risk presented when large volumes of funds are received from prepayments made during low interest rate periods, such as experienced during the early 1990s.

The overall quality of loans and leases held by banks in the Region, as measured by an analysis of overdue loans and charge-offs was 0.56 percent in the third quarter of 1996 and compares favorably to national average of 1.1 percent. *However, consumer loans, and credit card portfolios in particular, are an exception to this positive assessment. While credit card lending accounts for a small percentage of the total loan portfolio for banks in the Region, and is highly concentrated in the largest institutions, an overdue rate of 3.61 percent in those loans, up 36 percent since the end of 1995, strongly suggests that continued close attention should be given to underwriting and monitoring of all consumer loans.* In addition, the soaring rate of personal bankruptcies provides additional evidence that consumer loan portfolios warrant close attention by bank management and regulators (see ***Consumers Declare Bankruptcy in Record Numbers***).

Thrifts Record Losses for Third Quarter as a Result of the SAIF Special Assessment While Banks Continue to Generate Strong Earnings

Operating performance for both banks and thrifts was affected by the third quarter special assessment to capitalize SAIF; however, the negative impact was much greater for thrifts than banks (see ***SAIF Capitalized***). Regionwide, insured institutions paid $170 million or just under 4 percent of the total special assessment. Thrifts paid $113.5 million of the Region's assessment, resulting in a negative $19 million in net income for the quarter. However, year-to-date, thrifts still managed to generate positive income which results in an annualized return on average assets of approximately 65 basis points -- about two-thirds the level of performance achieved in 1995. Banks paid almost $56.5 million of the special assessment, an amount equal to 5 percent of their pre tax income. Despite this payment, the Region's banks were able to generate annualized return on average assets ranging from 1.24 percent in Kentucky to 1.45 percent in Mississippi -- exceeding the composite national figure of 1.19 percent. A further indication of the strong performance of the Region's banks is the fact that only 29 had negative net income for the period and 17 of those have been operating less than two years

Capital and Reserves Remain Strong

Capital levels grew modestly for most banks in the Region during the third quarter. *Overall, the capital cushion for banks remains well above required levels and approximately 15 percent above capital levels nationwide.* Banks in Louisiana and Tennessee have experienced slightly negative to flat capital growth rates while banks in Arkansas, Kentucky, and Mississippi experienced modest capital growth during the first three quarters of the year. For banks in Louisiana, a decline of approximately three quarters of one percent in the total risk-based capital ratio is attributable primarily to strong loan growth rates and

Table 1

Banks with Construction and Land Development (C&LD) Loan Exposures Exceeding 100% of Tier 1 Capital and 10% of Total Loans

State	Number of Institutions	Total Assets in 000s	C&LD* Total Loans	C&LD* Tier 1 Capital
Arkansas	20	3,040,025	14.36%	131.64%
Kentucky	6	470,788	14.16%	123.18%
Louisiana	7	428,400	16.09%	155.75%
Mississippi	0	0	0	0
Tennessee	24	2,960,439	16.69%	172.54%
Totals	57	6,899,652	NA	NA

* C&LD loans are weighted by total assets.
Source: Bank Call Reports

a decline in earning which also have caused flat growth in the leverage capital ratio. Strong asset and loan growth rates for Tennessee banks (approximately 10 percent) left capital coverage unchanged from the beginning of the year.

Capital levels for thrifts in the Region are above the national level, but display a much greater range than the Region's banks. Thrifts in Tennessee recorded the lowest level of capital coverage at approximately 7.5 percent (leverage ratio), which approximates the national figure, while institutions in Louisiana and Kentucky hold almost 50 percent higher capital levels.

Preferred Stock Issuance by Subsidiaries Attracts Attention

Banks in the Region seem to be hurrying to take advantage of a new financing technique before a possible repeal of favorable tax treatment which some expect to occur when Congress reconvenes in 1997. These so-called trust-preferred issues involve the creation of a real-estate investment trust (REIT) subsidiary and the sale of preferred shares in the subsidiary. *A number of large banking companies have utilized trust-preferred issues in recent months*. Key elements of the program are as follows:

- The parent company creates a subsidiary in which it places mortgages.
- The parent receives 100 percent of the common stock in exchange for the mortgage assets.
- Preferred stock in the subsidiary is sold to outside investors.
- On a consolidated basis the parent's investment in the subsidiary is eliminated and the preferred shares represent a minority interest generally considered a component of Tier 1 capital.
- Dividends on trust-preferred securities are presently tax deductible.

The attractiveness of trust-preferred issues is evidenced by the recent volume issued by depository institutions and insurance companies. A December 2, 1996, article in the ***Wall Street Journal*** noted that $10 billion of trust-preferred stock issued during the preceding two weeks directly affected the fixed-income market, stalling a rally in government bonds and weakening prices of corporate bonds.

Apparently, only one trust-preferred issue has apparently been completed to date where an insured institution is the parent company. In all other instances a holding company has been the parent company of the REIT. The Federal Reserve is permitting holding companies to recognize the preferred shares as Tier 1 capital upon consolidation. The FDIC is continuing to study the issue, but initially has expressed concern over permitting similar treatment to banks that might attempt to obtain funding through this structure. The primary areas of concern are the availability of funds obtained in this fashion to absorb losses at the bank level, and a requirement that REITs payout at least 95 percent of income. This feature has raised concern that the preferred shares would be cumulative and would not be considered capital of the bank. The FDIC's Division of Supervision is expected to issue guidance on this issue when their review of the matter is completed.

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